

H. FRATERNAL BENEFICIARY SOCIETIES AND FRATERNAL SOCIETIES

1. Introduction

Beginning with the Corporate Excise Tax Act of 1909, fraternal beneficiary societies that provide for the payment of life, sick, accident or other related benefits were exempted from taxation. They continued to be exempt under the Revenue Act of 1913 and have been exempt from every other Federal income tax act to date. They are currently exempt under IRC 501(c)(8).

2. Background

Initially, fraternal beneficiary societies were viewed as a type of mutual benefit organization. The benefits they provided were not insured benefits but were benefits provided according to the available resources of the group whenever need arose. As insurance became more common, fraternal societies were among the first groups to offer life insurance. Despite this activity, these societies were considered to be more than just insurance companies and the insurance aspects of the organizations were viewed as being only incidental to the fraternal and charitable purposes.

The language (that became current IRC 501(c)(8)) providing exemption for fraternal beneficiary societies has remained almost the same since the 1909 act. The only significant change was made by the 1913 act which extended exemption to organizations operating "for the exclusive benefit of the members of a fraternity itself operating under the lodge system." The purpose of the change apparently was to allow a separately organized insurance branch of a fraternal society to qualify for exemption.

IRC 501(c)(10) was enacted by the Tax Reform Act of 1969; it exempts fraternal societies which do not offer any insurance benefits to their members. It is generally understood that IRC 501(c)(10) was enacted largely at the urging of certain fraternal organizations that had been recognized under IRC 501(c)(8), but because they did not, or no longer wanted to, meet the requirements of IRC 501(c)(8) that they provide for the payment of life, sick, accident or other benefits to their members, sought a specific exempt category for fraternal organizations that did not pay such benefits.

3. General Characteristics

Fraternal beneficiary societies generally take the form of a secret society which has a set of secret rites and rituals. They engage in numerous activities of a social, educational and charitable nature. The only activities required of IRC 501(c)(8) organizations are that they actually operate under the lodge system, and that they either themselves provide for the payment of life, sick, accident or other benefits, or that they establish a separate (c)(8) entity which provides such benefits only for members of their organization.

Additionally, a (c)(8) organization must have a fraternal element -- a common bond -- among its members. The requirement of a fraternal element was set forth in Philadelphia and Reading Relief Association, 4 B.T.A. 713 (1926). The court there held that where the sole motive in joining an organization is to receive insurance benefits, and there are no lodges, rituals, ceremonies or regalia, then there is no fraternal element present. The court cited various cases where the terms "fraternal" and "fraternal-beneficial societies" were considered, among them is National Union v. Marlow, 74 F. 775 (8th Cir., 1896). There a fraternal beneficial society was defined as:

. . . one whose members have adopted the same or very similar, calling, avocation, or profession, or who are working in unison to accomplish some worthy object, and who for that reason have banded themselves together as an association or society to aid and assist one another, and to promote the common cause. The term 'fraternal' can properly be applied to such an association, for the reason that the pursuit of a common object, calling, or profession usually has a tendency to create a brotherly feeling among those who are thus engaged. . . Many of these associations make a practice of assisting their sick and disabled members, and of extending substantial aid to the families of deceased members. Their work is at the same time of a beneficial and fraternal character, because they aim to improve the condition of a class of persons who are engaged in a common pursuit, and to unite them by a stronger bond of sympathy and interest. . . .

An organization will not be classified as "fraternal" in nature where the only common bond among the majority of its members is the fact of membership in the organization. Polish Army Veterans Post 147, 24 T.C. 891 (1955), aff'd, 236 F. 2d 509 (3rd Cir. 1956). However, as noted in the National Union case, such a common bond may be inferred from membership in the organization. Further, mere

recitation of common ties and objectives in an organization's governing instrument is insufficient.

Finally, a fraternal beneficiary organization, to qualify for tax exemption under IRC 501(c)(8), must operate under the lodge system or for the exclusive benefit of members that so operate. Reg. 1.501(c)(8)-1 states that operating under the lodge system means "carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like." The intention to so operate is insufficient. An organization is operating under the lodge system only when the parent and local organizations are active; mere provision in the constitution and by-laws for such bodies is not enough.

There are no clear rules setting forth any minimum requirements regarding the regularity or frequency of membership meetings on the local level as long as the lodge system is effectively used as a means of maintaining a representative form of government. In addition, there are no specifications as to the kinds of activities an organization must engage in to be operated under the lodge system; however, the regulations under what is now IRC 501(c)(8) did at one time spell out those kinds of activities. Article 89 of Regulations 33, dealing with section 2 of the Income Tax Act of 1913 stated:

A society or association 'operating under the lodge system' is considered to be one organized under a charter, with properly appointed or elected officers, with an adopted ritual or ceremonial, holding meetings at stated intervals, and supported by fees, dues or assessments.

Revenue Ruling 73-165, 1973-1 C.B. 224, discusses the necessary ratio of fraternal activity to beneficial activity required of an IRC 501(c)(8) organization, and states that there is no requirement that either feature dominate so long as both are present in a substantial form and neither is a sham.

As noted above, an organization may be exempt under IRC 501(c)(8) even if it is not operated under the lodge system itself as long as it is operated for the exclusive benefit of the members of an IRC 501(c)(8) organization that is so operated. This area of IRC 501(c)(8) has not been really developed as yet, and the only published precedent on this type of organization is Rev. Rul. 73-192, 1973-1 C.B. 224, which states that a separate insurance branch of a fraternal beneficiary society can qualify for exemption.

4. Type of Benefits

IRC 501(c)(8) enumerates the allowable benefits an organization exempt under that section may provide as being "life, sick, accident or other." Very little discussion of what constitutes "other" benefits has appeared. It may be assumed from that language that similar benefits may be provided but that not any benefit is intended to be included. According to the 9th Circuit, the term "benefit in Code section 501(c)(8)(B) is not confined to insurance for members against personal risks such as disability or death, but may also extend to insuring them against property loss." Grange Insurance Association of California v. Commissioner, 317 F. 2d 222 (9th Cir. 1963). This decision overruled a prior Tax Court determination that fire insurance did not qualify as an "other" benefit as it was not similar to life, sick or accident insurance and that permissible benefits included only those related to mishaps to the person. The Service has not acquiesced in the position taken in the Grange case.

The benefits provided by these organizations must be to their members or their dependents. While not every member of the organization need be covered by the program (Rev. Rul. 64-194, 1964-1 C.B. 149), a substantial number must be. The Polish Army Veterans case, cited above, denied exemption to an organization where 90% of the members were not entitled to receive benefits.

In addition, where benefits to others outside the organization are incidental to the accomplishment of the society's exempt purpose, its exemption will not be jeopardized. Rev. Rul. 78-87, 1978-1 C.B. 160, describes a situation in which possible benefit to non-exempt entities was determined to be incidental to the accomplishment of a (c)(8)'s purposes. In that insurance, the (c)(8) participated in a state sponsored reinsurance pool along with non-exempt insurers. There was concern that the non-exempt insurers would derive a benefit from the participation of the (c)(8) and its payments into the pool; however, any such benefit derived was determined to be incidental to the accomplishment of the (c)(8)'s exempt purposes.

5. Deductibility of Contributions

Individual gifts to a fraternal beneficiary society may be deductible under IRC 170(c)(4); however, this deductibility applies only when the gift is to be used exclusively for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals. Contributions for fraternal or social purposes are not deductible. In addition, IRC 170(c)(4) does not permit a

deduction for contributions made for testing for public safety or fostering national or international amateur sports competitions.

6. Fraternal Societies-IRC 501(c)(10)

Fraternal societies are essentially the same as fraternal beneficiary societies except that no payments of benefits are offered. An organization not providing benefits but otherwise qualifying under IRC 501(c)(8) qualifies under IRC 501(c)(10). Difficult may be present, however, when distinguishing between an IRC 501(c)(10) fraternal society and an IRC 501(C)(7) social club due to the largely social nature of the activities of an IRC 501(c)(10) organization.

7. Differences Between Organizations Exempt Under IRC 501(c)(10) and 501(c)(7)

The basic distinction between these types of organizations is that IRC 501(c)(7) social clubs are generally not operated under a lodge system. Reg. 1.501(c)(10)-1(a)(2) states that an organization described in IRC 501(c)(7) may not qualify for exemption under IRC 501(c)(10) and specifically holds that a national college fraternity may not qualify as a fraternal society. The statute itself does not bar college fraternities from IRC 501(c)(10) status, and without this provision in the regulations, college fraternities might otherwise have qualified, as they are often operated under a lodge system.

IRC 501(c)(10) status is a more desirable classification than is IRC 501(c)(7) for two reasons:

1. IRC 501(c)(10) organizations are not subject to the IRC 501(c)(7) percentage limitations on nonmember and investment income; and,
2. IRC 501(c)(10) organizations are not subject to IRC 512(a)(3) which enumerates special rules on unrelated business taxable income for IRC 501(c)(7) organizations.

8. Differences Between Organizations Exempt Under IRC 501(c)(10) and 501(c)(8)

IRC 501(c)(10), unlike IRC 501(c)(8), contains a list of purposes for which fraternal societies must operate. These purposes are: religious, charitable, scientific, literary, educational, and fraternal. These are generally the same as those

traditionally pursued by IRC 501(c)(8) fraternal beneficiary societies. Also, IRC 501(c)(10) refers to "domestic" organizations and, therefore, only groups that are organized and operated in the United States can qualify under that section.

Finally, the statutory language of IRC 501(c)(8) exempts organizations which are operated for the exclusive benefit of other IRC 501(c)(8) organizations. The regulations suggest that any organization described in IRC 501(c)(8), but which does not provide benefits, might qualify for exemption under IRC 501(c)(10). IRC 501(c)(10) itself, however, does not refer to organizations operated for the exclusive benefit of other IRC 501(c)(10) organizations. The legislative history of IRC 501(c)(8) indicates that the "exclusive benefit" category was intended to grant exemption only to separate organizations providing payment of life, sick, and accident benefits. The Service takes the position that "exclusive benefit" organizations should not be exempt under IRC 501(c)(10) because they are not specifically described in that section, and because insurance benefits are not available under IRC 501(c)(10).